these differences offset each other in the calculation of net plant, there is no impact on revenue requirements, and therefore, no impact on customers. BellSouth specifically addresses each of the issues raised in the Inquiry's Issue 8 below.

1. Derivation of price cap rates and Re-initialization of price caps

Even if one assumed the audit results were accurate and that BellSouth had failed to make timely retirements from the plant accounts, determination of price cap rates would not have been effected.[78] The Commission initiated price cap regulation and set the initial price cap tariff rates for BellSouth on January 1, 1991. At that time, depreciation expense for regulated books and revenue requirement purposes was based on remaining life depreciation rates authorized by the Commission in 1989 and 1990.[79] The alleged CPR audit findings would have no impact on the determination of these initial price cap tariff rates for the following reasons. First, there would be no impact on the net investments that were used to determine price cap rates since recording the plant retirements to remove the alleged investment overstatements would reduce corresponding accumulated depreciation reserves by the same amount. Second, the audit findings would have had no measurable impact on depreciation expense because as BellSouth and others have demonstrated, depreciation expense calculated through the remaining life

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since investments and depreciation reserves decreased by the same amount.

[78] *See* Affidavit of Ronald E. White attached as Exhibit 5 to Bell Atlantic's Response to Audit Staff Draft of Findings Related to Audit of Continuing Property Records ¶ 7, ("[I]t is my opinion that annual revenue requirements for Bell Atlantic would not have materially changed if the omitted retirements in the plant accounting audit had been posted in the activity years in which plant was physically removed from service. It follows from this conclusion that a material bias was not created in the initial prices adopted under price cap regulation."); Taylor USTA Affidavit ¶ 27 ("No harm, no foul. Even if the conclusions of the audit were correct – that a large amount but small percentage of LEC assets in the CPR cannot be located – ratepayers would have suffered no harm.")

[79] Prior to 1996 BellSouth transacted business under two separate Bell operating companies – Southern Bell and South Central Bell. The rates for Southern Bell were authorized in 1989, while the rates for South Central Bell were authorized in 1990.

depreciation methodology is not impacted by a failure to timely retire an asset.[80] Finally, BellSouth has been conducting a complete physical inventory of its hardwired COE over the last eight years, including approximately 1/8 of these investments each year. Since an inventory audit is simply a snap-shot in time, there is no basis to assume that a current discrepancy existed in a prior period. Indeed, BellSouth's periodic physical inventories over the eight year cycle, when complete, should lead to the conclusion that impacts on the initial price cap rates is highly unlikely. Therefore, BellSouth contends that it has a reasonable process in place to periodically inventory and true-up its COE investments and that any misstatement to investments that may inadvertently occur from time to time has no impact on ratepayers.

2. Sharing

The Commission's price cap regulation plan in effect from January 1, 1991 through June 30, 1995 required earnings sharing if a company's earnings exceeded a threshold rate of return on its interstate rate base. Effective July 1, 1995 the price cap plan was modified to allow a company the option of no sharing if it agreed to a 5.3% productivity offset factor (X-factor in the price cap formula). The price cap plan was further modified effective July 1, 1997 to require a 6.5% productivity offset with no sharing required.

For the period January 1, 1991 through June 30, 1995, BellSouth met the sharing threshold and reduced its rates to pass on the customers' share of earnings. The amount of sharing that was calculated for these years would not be impacted by the alleged CPR audit findings for the same reasons that the initial price cap rates were not impacted. (See 1 *supra*) Because neither depreciation expense nor net investment is impacted by the audit findings, the

[80] BellSouth also points out that the Report audit period, July 1997, was well beyond the implementation date for price caps. It is axiomatic in auditing that no conclusions can be reached regarding asset investment balances in 1991 from an audit performed six years after the

Company's achieved return on rate base would be the same as originally reported. Therefore, the sharing amounts for this period would not change.

For the period July 1, 1995 forward, BellSouth has used productivity offset factors that required no sharing of earnings. The question of an impact on sharing is therefore, not relevant to this time period.

3. Lower Formula adjustments

A Lower Formula adjustment is a component of the price cap plan that allows a company to increase prices if its earnings drop below a set threshold return on interstate rate base. BellSouth has not utilized the Lower Formula adjustment at any time during price cap regulation, therefore, any changes required by the CPR audit could not impact BellSouth. BellSouth recognizes that a LEC's costs may become relevant in the event the LEC seeks a low-end adjustment. Continued CPR requirements to test costs, including depreciation, to analyze the uncommon instance of a low-end adjustment, however, is illogical and a colossal waste of resources. If a price cap LEC seeks a low-end adjustment, the Commission can place the burden on that LEC to justify its costs.

4. Exogenous cost calculations

Exogenous costs under price cap regulation are cost changes outside of a carrier's control that may be used to increase or decrease the price cap indexes. LECs subject to price cap regulation file annual adjustments to the price cap index for each basket as a part of the annual price cap filing. BellSouth has made a number of changes to its price cap indexes based on exogenous cost adjustments since the price cap plan was initiated.

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fact.

The alleged CPR audit adjustments would not impact BellSouth's revenue requirement impacts associated with exogenous events. The revenue requirement methodology would not be impacted because as explained under Issue 1 *supra*, net investment and depreciation expense are unaffected by the alleged reporting discrepancies.

5. Changes to or Setting the Productivity Factors

The alleged findings in the Report would have no effect on the past or current calculations of productivity factors. First, past values of the productivity factors were based "on the average of the short-term and the long-term trends in rate reductions prior to [the Commission's] adoption of the original price cap plan in 1990, plus a consumer productivity dividend (CPD) of 0.5 percent."[81] The studies to develop these trends were based on figures that were all prior to the July 1997 figures audited, and therefore the alleged finding in the Report would not have effected these studies.[82]

In the recent price cap plan, productivity factors are based on a total factor productivity ("TFP") method "based measure of productivity and an input price differential."[83] "Total factor productivity for an industry is calculated by combining accounting measures of inputs and outputs for all of the firms in the industry and measuring the difference in the rates of growth of aggregate output and aggregate inputs."[84]

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81 *In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform*, CC Docket Nos. 94-1, 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16648 (1997) ("*Fourth Report and Order*").

82 *See* Taylor USTA Affidavit ¶ 23.

83 *Fourth Report and Order* at 16648.

84 Taylor USTA Affidavit ¶ 24.

The TFP model does consider capital stock (investment) and depreciation as inputs to the model. Even assuming the Report findings to be accurate and retirements were delayed, however, that fact would have caused no negative impact to the productivity factor calculations. Indeed, the impact of delayed retirements capital stock would have at worst cause the productivity factors to remain constant and at best caused them to be lowered.[85] This in turn would have caused the price index to be higher and potentially higher prices for consumers.[86]

Moreover, as discussed above, the principles of the remaining life depreciation methodology produce depreciation expense amounts that are no more than nominally impacted by an inaccuracy in retirement reporting. Productivity factors, however, would only be effected if depreciation expense changed materially.[87] Because the depreciation expense impact is negligible there would be no impact on productivity factors.[88]

6. Joint Cost Allocations

Joint cost allocations relate to the procedures that BellSouth is required to follow to separate its total costs between regulated and non-regulated services. BellSouth follows the Commission's Part 64 rules and its Cost Allocation Manual ("CAM") in performing these joint cost allocations. Since the Bureau audit sampled total hardwired COE investments with no distinction as to the regulated or non-regulated status of the plant items, joint cost allocation relationships between regulated and non-regulated would logically not be impacted by the alleged CPR investment overstatement. This conclusion is based on the assumption that the

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85 *See id.* ¶ 25.

86 *Id.*

87 *See* Gallop Affidavit.

88 *See also* Taylor USTA Affidavit ¶ 26 ("the key element is whether depreciation rates remain constant over the period; if depreciation rates remain constant, it does not matter whether they are constant at a high or low level.")

audit adjustments would relate to both regulated and non-regulated investments in the same proportion that each existed in the universe of items sampled. Therefore, regulated and non-regulated cost allocation factors would not change provided equitable reductions in regulated and non-regulated investments were made. If a determination could be made that regulated and non-regulated investments per the audit findings were not in the same proportion as total regulated and non-regulated plant, then a very minor expense shift could occur. The magnitude of such a change would be miniscule. To estimate the size of any possible impact, BellSouth performed an analysis that assumed the entire alleged discrepancy in plant in service was related to regulated investments. This analysis yielded a result of an annual expense shift between regulated and non-regulated expenses of less than ten thousand dollars.

7. Separations

The separations effects of reducing COE gross plant balances for the alleged audit findings would have an insignificant impact on BellSouth interstate investments and related interstate expenses. This outcome is logical because the alleged audit findings do not impact the relative usage measurements used in the separations methodologies and, as previously explained in response to item 1, net investment is not impacted by the audit findings. Potential jurisdictional separations impacts could result from changes in the relative distribution of telephone plant in service by investment categories and the resultant impacts on accumulated depreciation reserve by plant category. To test for the size of any such impacts, BellSouth performed calculations in its jurisdictional separations process that applied the full amount of the alleged audit discrepancies as reductions to plant investments and depreciation reserves. The output of these calculations showed a change in interstate net investments of about $80,000 and interstate expenses of about $134,000 annually. These amounts are certainly not material impacts to BellSouth's separations results.

8. Access charges

Access rates would not be impacted by the alleged findings in the Report. As explained in response to items 1 through 6, there is no significant impact on the initial price cap rates, sharing, exogenous cost adjustments, joint cost allocations, separations, or any other issues which would impact access charges.

9. Ratemaking

Ratemaking adjustments would normally be based on the impacts of items 4 through 8 above. However, since these issues have virtually no impact on interstate net investment or expenses, rates would not be affected by these changes.

ISSUE 9: Whether the property record discrepancies have any impact on (1) calculations under the Telecommunications Act of 1996 relating to (a) universal service support and (b) pricing of unbundled network elements, and (2) the merits of "takings" claims and "stranded costs" recovery

Retirement accounting does not affect either the pricing of BellSouth's unbundled network elements or universal service fund support under the methodology proposed by the Commission, which are based on forward looking economic costs, not historical costs. Forward-looking economic costs do not rely on the accuracy of BellSouth's CPR.[89]

Item (1)(a) -- USF

The alleged CPR discrepancy would have no material impact on Universal Service cost calculations per the Telecommunications Act of 1996. The plant specific Universal Service Support cost factors would be affected to a small degree if BST were to adjust COE investments

[89] The existing high cost fund, which does look at book costs, will not be used for non-rural

in accordance with FCC recommendations. Plant specific cost factors are applied to network investments in order to develop the annual costs that are necessary to maintain these investments. A review of the methodology used to calculate these plant specific factors indicates that a small increase in the factors would result from reductions in gross COE investment (same level of maintenance expense divided by an investment base that has been reduced by the recommended CPR related adjustments). Circuit and switching related plant specific costs represent less than 5% of total Universal Service Support costs. Therefore, the potential impact on Universal Service Support filings would be *immaterial*. It is also important to note that the consequences of any impact that could result would be an increase in BellSouth's cost for Universal Service.

Item (1)(b) -- Pricing of unbundled network elements

The alleged CPR discrepancy would have no material impact on the pricing of Unbundled Network Elements ("UNEs"). Two sets of factors would be affected to a small degree if BST were to adjust its gross COE investments in accordance with FCC recommendations. The shared and common cost UNE factors are developed based on the costs that are shared by multiple products/services or that are common across all products/services without having a direct relationship to a single product or service. These costs are ratioed to the direct costs of the business in order to develop the shared and common cost factors. With regard to the recommended CPR adjustments, there would be no change in the shared and common costs; however, the direct cost base would decrease slightly as a result of the COE related investment reductions. This would result in a very small increase in shared and common cost factors.

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local exchange carriers, like BellSouth, beyond 1999.

Additionally, plant specific cost factors are applied to network investments associated with UNEs in order to develop the annual costs that are necessary to maintain the network investment. For the UNEs that have circuit or switching investment associated with them, the plant specific factors would reflect a small increase (same level of maintenance expense divided by an investment base that has been reduced by the recommended CPR related adjustments). There would be a very small increase in the related plant specific factors.

In summary, the bottom line impact on UNE prices could be a small increase in these prices. This assumes that the various shared and common and plant specific factors were adjusted as described above and that the State Commissions accepted the adjustments.

Item (2)(a) – Takings Claim

The theory behind a regulatory taking stems from an entity having a constitutional right to an opportunity to recover its costs of providing services, including a reasonable return on the fair value of its assets. A constitutional taking occurs if a governmental agency deprives the entity of the opportunity to recover its costs and reasonable return.[90] After the release of the first audit and in the ensuing period the Bureau has made vague allegations that the alleged discrepancies it found in the audit will have an impact on determining whether a taking has occurred. Such an allegation is completely without merit.

First, in order for the alleged audit discrepancies to impact regulatory taking, BellSouth would have to allege such a taking. BellSouth has not alleged a regulatory taking, so the issue is purely hypothetical at this time. Second, even if BellSouth did allege a regulatory taking, the cost analysis would be based on net plant, i.e., fixed plant assets less accumulated depreciation. The Report, BellSouth's Response, and these comments have discussed both the "missing asset"

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90 *See generally Bluefield Water Works v. PSC of West Virginia*, 262 U.S. 679 (1923).

and "Undetailed investment" components of the audit. The audit does not allege that the missing asset component is the result of improperly inflating fixed assets, but was caused by mistimed retirements. BellSouth has explained in detail that a retirement has no impact on net plant because it merely reduces both fixed plant assets and accumulated depreciation. Accordingly, even if the missing assets alleged by the Report were accurate, they would have no impact on a takings claim.

The Undetailed Investment component would also not cause a reduction in net fixed plant. A forced adjustment would merely cause the assets to be detailed to specific CPR location. Thus, the Undetailed Investment would be reduced, but the fixed plant assets would be increased. Consequently, there would be no impact on a potential takings claim.

Item (2)(b) – Stranded Cost Recovery

Just as with a takings claim, any claim regarding stranded cost would involve net fixed plant. Accordingly, for the same reasons discussed in the takings section above, the alleged discrepancies from the audit would have no impact on stranded cost recovery.

ISSUE 10: Any other issue or issues pertinent to the audit reports or the company responses. These issues may include but are not limited to: (1) the benefits of compliance with our rules, as well as the consistency of these rules with other statutory and regulatory policies; (2) the reasonableness of the auditors' interpretations of the CPR requirements; (3) the history and consistency of the FCC's procedure and enforcement of these requirements and, (4) what other federal and state agencies do and what Generally Accepted Accounting Principles (GAAP) requires to ensure the accuracy of books and records

1. The benefits of compliance with CPR rules, as well as the consistency of these rules with other statutory and regulatory policies

The CPR rules provide little or no benefit to large carriers or the Commission in today's regulatory environment. These rules were created when carriers were regulated by rate of return regulation for setting prices. This is no longer the case. The need for such regulation has been eliminated by the implementation of price cap regulation. Price cap regulation focuses on prices a local exchange carrier ("LEC") may set for its services instead of the cost to provide the services.[91] Indeed, the cost of the service is no longer relevant to the price that a price-cap LEC charges a customer for a service. Such useless regulation is in direct contradiction to the de-regulatory intent of the 1996 Act. Congress clearly recognized that many carriers are saddled with regulation that has outlived its usefulness and should therefore be eliminated. Consequently, Congress included Section 10 in the 1996 Act as a mandate to rid the industry of such unneeded regulation. The CPR requirements are certainly ripe for the application of Section 10 forbearance.

This is clearly evident in the Arthur Andersen Report. That report analyzed many of the existing accounting requirements, including property records. In addressing the detail plant accounting records the Arthur Andersen Report stated:

> In a price cap environment ··· such plant accounting detail is no longer of paramount importance as prices charged for regulated services are regulated instead of costs incurred and plant investment utilized to provide such services. In the same manner, the detailed depreciation rate represcription process is no longer cost-beneficial, as costs no longer have a direct bearing on the determination of prices under price caps.[92]

This is exactly the point made by Commissioner Furchtgott-Roth when he stated "to the extent that accurate plant accounts play any continuing role in monitoring financial results, defining stranded investment or calculating low-end adjustments, these mechanisms are mere relics of rate of service regulation and should be eliminated in today's increasingly competitive

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91 *Price Cap Order* at 6792.

92 Arthur Andersen Report at 31.

environment." Accordingly, the Commission should abandon its myopic view of this regulation and must follow the mandate of the 1996 Act and forbearance in this area.

2. The reasonable of the auditors' interpretations of the CPR

The auditors have been unrealistic in their application of the rules in question. It appeared during the audit that the slightest deviation from the auditors' interpretation of a rule meant that BellSouth was found to be out of compliance. The standard for compliance with the rules is not absolute perfection. Rules that require absolute perfection are arbitrary and capricious and cannot form the basis for an enforcement action.[93] Indeed, BellSouth challenges the Commission to find any organization with physical assets of equal size to BellSouth's that can claim perfection in its property accounting records. It cannot.[94] The truth is, when a company has physical investment in Hard-Wired Equipment that exceeds $8.7 billion, some mistakes will occur – it cannot be avoided. This does not mean, however, that the investment records are materially misstated. In fact, BellSouth contends that under a reasonable interpretation of the rules, its records are in excellent condition and accurate in all material respects. Thus, the standard of perfection may be quixotic, but it cannot and it should not be expected from BellSouth, or from any local exchange carrier, in its CPR.[95]

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93 *AT&T v. FCC*, 299 U.S. 232, 245 (1936) ("Penalties do not follow upon innocent mistakes.")

94 The property records of the Federal Government itself contain error rates comparable to those alleged in the Report. *See*, United States General Accounting Office, Report to Congress, Financial Audit 1997 Consolidated Financial Statements of the United States Government, March 1998.

95 *See* Commissioner Furchtgott-Roth's separate statement at 8 ("Our rules do not require such a precise location [specific bay or shelf] be maintained for every piece of equipment.")

3. The history and consistency of the FCC's procedure and enforcement of these requirements

Since the implementation of the CPR requirements, the Commission has never performed an audit and issued a report regarding these rules.[96] Indeed, BellSouth has never received guidance from the Commission regarding its interpretation of the CPR requirements. As Commissioner Furchtgott-Roth stated in his separate statement "the Commission never found it necessary to perform the type of sweeping audit that was conducted here. Nor had the Commission ever enforced its accounting rules in such an exacting manner."

The inconsistency in the Commission's enforcement of these rules is illustrated by a comparison between the current audit and a 1994 audit it conducted, but never provided any form of feedback. For the 1994 audit, the auditors conducted an on-site visit and examined plant assets and supporting assets. Although questions arose during the audit, there were never any discussions regarding the non-acceptance or non-compliance of BellSouth's cost verification or proof of any assets' existence. To the contrary, the auditors gave BellSouth the clear and distinct impression that BellSouth was in compliance with the Commission's CPR record keeping requirements; and, in fact, had the best records of any of the prior five carriers that had been audited. The auditors gave particular accolades to the Asset Management Group established in the network department for the control and identification of asset retirement units. The auditors commented that BellSouth was the only large LEC the auditors had examined that had established such an oversight group.

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[96] The Bureau did perform an audit in 1994. No one from BellSouth, however, was informed about the results of the 1994 audit. Indeed, the section in the Report discussing the 1994 audit was the first comments BellSouth has seen regarding the audit since its conclusion. Moreover, the comments in the Report are completely inconsistent with the discussions the auditors held with BellSouth during the audit.

The inconsistencies in the 1994 audit and the 1997 audit are further exacerbated by the fact that the auditors put contradictory statements in the Report regarding the 1994 audit. Indeed, the comments are completely contrary to all previous contacts with the auditors regarding the 1994 audit. Section VI of the Report even declares that "we first became aware of the nature and scope of this problem during our 1994 audit of [BellSouth's] CPR. That audit demonstrated that the problems were so pronounced and prevalent as to make it highly unlikely that the errors had developed in a relatively short period of time." If the problems were "pronounced and prevalent" why were the problems not reported to BellSouth? The Report's declaration that "informal discussions were held with each carrier regarding the problems found in their respective CPR," is absolutely false in BellSouth's case. In all informal discussions held between the auditors and BellSouth, not once did the auditors communicate a problem to BellSouth. If the auditors had reported any audit problems that merited change, BellSouth would gladly have made such changes.

The Report includes an appendix summarizing the 1994 audit results. BellSouth unequivocally disputes every conclusion and finding in this appendix. Even if one assumed they were true, however, BellSouth believes it is inappropriate to not reveal the results until 4 years after the fact, and then, only in a report related to a subsequent audit instead of in a separate report. The lack of timely communication of the results of the 1994 audit is inappropriate on its face and highly disturbing in the light of the seriousness of the allegations the audit staff has made in the Report.

One of the chief purposes of a Commission audit should be to inform the carrier of any problems encountered during the audit. This is particularly true if the Commission deems that the problems require corrective action on the carrier's part. Absent such disclosure, how can the

Commission expect the carrier to change the activity that the Commission considers to be improper?

4. What other federal and state agencies do and what Generally Accepted Accounting Principles ("GAAP") requires to ensure the accuracy of books and records

Many government agencies, including the General Accounting Office, follow Generally Accepted Government Auditing Standards ("GAGAS") in conducting their audits. These standards state that the "auditors should prepare written reports communicating the results of each audit."[97] These standards also state that the report should be issued in order "to make the information available for timely use by management ···."[98] Moreover, the standards state that the results of the audit should be first discussed with the appropriate management officials before the report is even issued.[99] The auditors did none of these things.

As for a status of state regulatory reporting requirements, BellSouth has prepared a matrix, attached as Exhibit 7, which compares the reporting requirements of the state public service commissions in its nine-state region.

CONCLUSION

Based on the preceding comments one thing is absolutely clear — the CPR audits are a waste of time for both the incumbent LECS and the Commission. They were based on faulty auditing procedures and invalid statistical sampling methods that render the audit results useless.

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97 Government Auditing Standards: 1994 Revision, issued by the United States General Accounting Office, Comptroller General of the United States (June 1994) (hereinafter "Yellow Book") ¶ 7.2. *See also*, Generally Accepted Auditing Standards ("GAAS") used by certified public accountants to audit the financial records of public companies as required by the Securities Exchange Commission. Four of the ten standards are dedicated to reporting the audit results. Frank C. Minter et al., Handbook of Accounting and Auditing § B1.06. (1998).

98 Yellow Book ¶ 7.6.

99 *Id.* ¶ 7.39.

Moreover, even if the results were reliable, which they are not, they would have no impact on consumer prices. Accordingly, the Commission should take no action based on the auditor's recommendations.

Respectfully submitted,

BELLSOUTH CORPORATION AND
BELLSOUTH TELECOMMUNICATIONS, INC.

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Date: September 23, 1999

CERTIFICATE OF SERVICE

I do hereby certify that I have this 23rd day of September, 1999, served the following parties to this action with a copy of the foregoing ***COMMENTS OF BELLSOUTH***, reference CC Docket No. 99-117 and ASD File No. 99-22, by hand delivery or by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties as set forth below.

Magalie Roman Salas, Commission Secretary*
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Lenora Biera-Lewis

* **VIA HAND DELIVERY**

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Exhibit 1

Arthur
Andersen

Accounting Simplification in the Communications Industry

July 15 Report

ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

July 15, 1998

ARTHUR
ANDERSEN

ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

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ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

I. INTRODUCTION

Arthur Andersen LLP ("Arthur Andersen")[1] was engaged to prepare this position paper entitled "Accounting Simplification in the Telecommunications Industry" by a coalition of local exchange carriers ("LECs") including Ameritech Corporation, BellSouth Corporation, GTE Service Corporation, SBC Communications Inc. and U S WEST, Inc. ("the LEC Coalition"). This paper will analyze the Federal Communications Commission's ("FCC" or "Commission") Uniform System of Accounts ("USOA") for Telecommunications Companies contained in Part 32 of the FCC's Rules and Regulations and identify and recommend opportunities for simplification and streamlining. These simplification opportunities should be adopted in order to further the industry's move to a competitive, deregulated environment. This will help eliminate unnecessary constraints of USOA rules and regulations where competing classes of service providers are not bound by such requirements.

The overall conclusion of Arthur Andersen is that the USOA does not reflect the existing regulatory and competitive paradigm. Rather, the USOA has evolved into a regulatory reporting system solely to meet regulatory reporting requirements. As such, the USOA imposes an unnecessary and costly constraint on the carriers subject to its requirements. Such requirements should be streamlined and/or eliminated in order to provide subject carriers the increased flexibility necessary in today's competitive environment and to move the LEC industry towards accounting and recordkeeping "best practices" utilized by their competitors and companies outside of the local exchange telecommunications industry.

The accounting rules embodied in Part 32 (in particular the level of accounting and recordkeeping specificity required) were developed principally to support rate of return regulation in the absence of competition. As all LEC Coalition members and many other large LECs have adopted price cap regulation without earnings sharing in the interstate jurisdiction (and in the majority of state jurisdictions), and as increased competition is the overall goal of the Telecommunications Act of 1996 (the "Telecommunications Act"), those accounting and recordkeeping requirements designed in support of traditional rate of return regulation are no longer necessary.

The USOA imposes significant recordkeeping requirements on subject carriers that bring with them significant costs of compliance. The continuing benefits associated with many of these requirements are unclear, given the current regulatory and competitive paradigm. Further, competitors to the LECs are not subject to the same USOA

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[1] Arthur Andersen is a global multi-disciplinary professional service firm that helps its clients improve their business performance through assurance and business advisory services, business consulting, economic and financial consulting, and tax, legal and business advisory services. With more than $5 billion in revenues, and 58,000 employees, Arthur Andersen serves clients in more than 363 locations in 78 countries.

requirements but must comply with only generally accepted accounting principles ("GAAP"). These "costs of regulation" are very real and must be considered in today's competitive environment.

As described in Section 32.1 of Part 32, "The [revised] USOA is a historical financial accounting system which reports the results of operational and financial events in a manner which enables both management and regulators to assess these results within a specified accounting period. The USOA also provides the financial community and others with financial performance results. In order for an accounting system to fulfill these purposes, it must exhibit consistency and stability in financial reporting (including the results published for regulatory purposes). Accordingly, the USOA has been designed to reflect stable, recurring financial data based to the extent regulatory considerations permit upon the consistency of the well established body of accounting theories and principles commonly referred to as generally accepted accounting principles."[2] The Part 32 Rules became effective on January 1, 1988, replacing the prior Parts 31 and 33 as the new accounting system.

A careful analysis of the above Part 32 "mission statement" reveals that, in today's industry environment, the USOA fails to accomplish many of the objectives stated above. For example:

- Management no longer utilizes USOA results to manage the business – in particular, the expenses as categorized under Part 32 do not present a clear picture of activities performed to produce a product or service. Thus, companies have designed management information systems that focus on activity-based cost information (e.g., salaries and wages, by activity or service, versus buried cable expense).

- The financial community for the most part no longer uses the financial results derived pursuant to Part 32. Each of the LEC Coalition members as well as several other LECs have discontinued the application of Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," in producing their audited financial statements that are filed with the Securities and Exchange Commission ("SEC") and published to the financial community. Additionally, these published statements are a better reflection of the LECs' actuals economic environment and performance than statements derived pursuant to Part 32.

- The stability of the USOA should also be closely looked at. In light of the tremendous changes in the industry since its adoption in 1988, in many respects the USOA's stability has rendered it obsolete as an accounting system intended to reflect the current results of operations of subject carriers in a consistent and relevant manner.

[2] 47 CFR §32.1

**ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY**

Prepared by Arthur Andersen LLP

Arthur Andersen recommends that the FCC carefully review the continued applicability of the Part 32 USOA and its detailed accounting and recordkeeping requirements for **all** carriers, not just those falling beneath an arbitrary threshold. Arthur Andersen demonstrates that the simplification proposals discussed in this paper provide for such a transition from today's detailed Part 32 regulatory accounting and recordkeeping requirements to more of a "level playing field" where all carriers are subject to the same requirements under GAAP. These recommendations can be adopted now to ease the accounting and recordkeeping requirements on **all** LECs with the ultimate goal being full reliance on GAAP.